UNDER SECRETARY OF DEFENSE
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COMPTROLLER

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MEMORANDUM FOR SECRETARIES OF THE MILITARY DEPARTMENTS
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SUBJECT: Department of Defense (DoD) Internal Use Software Financial Management Policy

Attached is the Department's current financial management policy for internal use software. This policy should be implemented. immediately throughout your respective organizations. This policy will be included in the next update to the "DoD Financial Management Regulation," Volume 4, Chapter 6 scheduled for third quarter of fiscal year 2004.

My staff point of contact for this matter may be reached by telephone at (703) 697-0503.

/s/
Lawrence J. Lanzillota
Acting

Attachment:
As stated

Internal Use Software (Account 1830)

A. Definition. Internal Use Software includes application and operating system programs, procedures, rules, and any associated documentation pertaining to the operation of a computer system or program that is used for operational or other internal use. Normally, software is an integral part of an overall system(s) having interrelationships between software, hardware, personnel, procedures, controls, and data. Internal Use Software does not include software integrated in military equipment or other computer operated equipment or systems, nor does it include software used in Special Test Equipment. Internal Use Software is software that is:

1. Purchased from commercial off-the-shelf (COTS) vendors and is ready for use with little or no changes,

2. Developed by employees of the DoD, including new software and existing or purchased software that is modified with or without a contractor's assistance, or

3. Contractor-developed software that the DoD paid a contractor to design, program, install, and implement, including new software and the modification of existing or purchased software.

4. Internal Use Software includes acquisition, finance, logistics, personnel or other business related systems.

B. Recognition and Measurement. Internal Use Software is recognized and capitalized if it has a useful life of 2 years or more, provides a significant increase in functionality that is visible to the user (in the case of enhancements) and the cost of the software or enhancement equals or exceeds the DoD capitalization threshold. An upgrade is not necessarily a capital improvement. If an upgrade modernizes an operating system, it is normally expensed since the user does not see a significant increase in functionality. As development work accumulates, the costs will be entered into an Internal Use Software In Development account (Account 1832). When the software is accepted, the accumulated costs shall be removed from this "In Development" account, and the cost of the software or enhancement shall be transferred to the Internal Use Software account (Account 1830). Table 1 provides examples of these accounting transactions.

1. COTS Software. The capitalized cost of COTS software shall be the actual purchase price, plus any costs incurred for implementation.

2. Contractor Developed Software. The capitalized cost of contractor developed software shall include the amount paid to the contractor to design, program, install, and implement the new software or to modify existing or COTS software, plus any costs incurred for implementation.

3. Internally Developed Software. The capitalized cost of internally developed software shall include the full cost (direct and indirect costs) incurred during the software development phase. Full cost includes the costs of new software (e.g., contract costs, salaries of

programmers, systems analysts, project managers, and administrative personnel; associated employee benefits; outside consultants' fees; rent; and supplies and overhead) and technical documentation. The development of technical documentation and manuals is capitalized. The cost of mass producing manuals is expensed. Project management (direct labor) costs are those costs specifically associated with a particular project and are capitalized. Program management (indirect labor) costs are labor costs associated with an entire program consisting of several individual projects. The costs of program management and the Program Management Office (PMO) that may be incurred during each phase of software development or acquisition project shall be expensed or capitalized depending on their materiality to overall costs of individual software development projects and each phase and/or preponderance of development or acquisition work. Capitalized costs shall be limited to costs incurred after the preliminary design phase. Figure 1 provides a matrix of software acquisition and development costs and provides additional guidance regarding whether such costs will be expensed or capitalized. The various types of costs incurred during software acquisition and development are explained below.

a. Direct Labor Costs: Direct labor costs are typically the labor costs of project teams (e.g. programmers, engineers, managers) and are capitalized as part of the costs of the software project. Direct labor costs shall be tracked by project managers and/or program managers and allocated to individual software projects, as appropriate, if project personnel are working on more than one software project. The allocation methodology must be consistent between projects and must be auditable.

b. Indirect Labor Costs: Indirect labor costs are typically the labor costs associated with Program Management Office (PMO) personnel responsible for overseeing more than one software project. In many instances, PMO indirect labor costs are immaterial when compared with the overall costs of a software project, and if determined to be immaterial, will be expensed. PMO indirect costs shall be expensed or capitalized, depending on: 1) their materiality to overall costs of individual software development projects and 2) in which phase the costs were incurred. Decisions regarding the materiality of indirect labor costs, when such costs are to be expensed, must be justified, documented and must stand up to audit scrutiny. If indirect labor costs are determined to be material to a software project or projects and are to be distributed to the capitalized costs of such project, the costs shall be allocated based on a distribution methodology that it is both documented and auditable.

c. Overhead Costs: Overhead costs are those costs associated with utilities, building maintenance, supplies, etc. that are essential to the overall accomplishment of a software project. In many instances, overhead costs are immaterial when compared with the overall costs of a software project, and if determined to be immaterial, will be expensed. Decisions regarding the materiality of overhead costs, when such costs are to be expensed, must be justified, documented and must stand up to audit scrutiny. If overhead costs are determined to be material to a software project or projects and are to be distributed to the capitalized costs of such project, the costs shall be allocated based on a distribution methodology that it is both documented and auditable.

d. Contractor Costs: Contract costs must be evaluated to determine whether the costs are to be expensed or capitalized. Such determination is based on the type of work performed by the contractors. Figure 1 provides a breakdown of the various work activities and whether the cost of such activities must be expensed or capitalized.

SOFTWARE ACQUISITION PHASES

PRELIMINARY DESIGN PHASE	SOFTWARE DEVELOPMENT PHASE	POST-IMPLEMENTATION/ OPERATIONAL PHASE
EXPENSE COSTS	**CAPITALIZE COSTS**	**EXPENSES COSTS**
Activities: • Determination of existence of needed technology • Conceptual formulation of alternatives • Evaluation and testing of alternatives • Final selection of alternatives	Activities: • Design of chosen path, including software configuration and software interfaces • Coding • Technical documentation • Development of user manuals • Installation on hardware • Testing, including parallel processing • Training development	Activities: • Data conversion (includes cleansing, deleting, and repackaging data) • Application maintenance • Implementation assistance (e.g., troubleshooting, system analysis, producing and printing users manuals desk procedures, and similar support to the project's customers)
This phase includes all actions leading to source selection of a COTS or other commercial source. For internally developed software, this phase includes all actions prior to System Requirements Specification (SRS).	Software development starts after the Preliminary Design Phase and includes all development actions such as design, programming and installation.	Post-implementation includes all operational testing and evaluation, as well as other functional testing conducted after technical acceptance and includes costs incurred to make customer ease of use changes.
PROGRAM MANAGEMENT The costs of program management and the Program Management Office (PMO) that may be incurred during each phase of software development or acquisition are indirect costs. PMO indirect costs shall be expensed or capitalized, depending on: 1) their materiality to overall costs of individual software development projects and 2) in which phase the costs were incurred.		

Figure 1

4. Software Developed by One Activity and Used by Others Without Reimbursement. Software that is developed by one activity and used by another activity or activities without reimbursement shall be capitalized and depreciated by the developing activity (if it meets the capitalization criteria). For example, if the Tricare Management Activity (TMA), of the Defense Health Program, develops software (that meets the capitalization criteria) and installs the software at multiple DoD medical treatment facilities, the TMA shall capitalize and depreciate the software. The cost of the software shall not be allocated to the using activities.

C. Data Conversion Costs. All data conversion costs incurred for internally developed, contractor developed, or COTS software shall be expensed as incurred, including the cost to develop or obtain software that allows for access or conversion of existing data to the new software. Such costs may include the purging or cleansing of existing data, reconciliation or balancing of data, and the creation of new or additional data.

D. Costs Incurred After Final Acceptance Testing (Cutoff). Costs incurred after final acceptance testing has been successfully completed shall be expensed. Acceptance testing is that testing undertaken to verify if a software product meets specifications. Operational testing and evaluation and other functional testing conducted to ease customer use after technical acceptance shall be expensed. When the software is to be installed and capitalized at multiple sites, capitalization phase ends after acceptance testing is complete at each of those sites.

E. Integrated (Embedded) Software. Computer software that is integrated into (embedded) and necessary to operate equipment (rather than perform an application) shall be considered part of the equipment of which it is an integral part and capitalized and depreciated as part the cost of the equipment (e.g., airport radar and computer-operated lathes). The aggregate cost of the hardware and software shall be used to determine whether to capitalize or expense the costs.

F. Bundled Products and Services. The cost of software purchased as part of a package of products and services (e.g., training, maintenance, data conversion, reengineering, site licenses, and rights to future upgrades and enhancements) shall be allocated as capitalizable and non-capitalizable (expensed) costs based on a reasonable estimate of the value of the individual products and services.

G. Bulk Purchases of Software. Bulk purchases of software programs and modules or components of a total software system that individually meet the DoD capitalization threshold shall be capitalized. If the per item cost of a bulk purchase (e.g., numerous copies of spreadsheets and word-processing programs) does not meet the DoD capitalization threshold, the bulk purchase shall be expensed.

H. Enhancements

1. The acquisition cost of enhancements to existing Internal Use Software (and modules thereof) shall be capitalized when such costs exceed the DoD capitalization threshold, and when it is more likely than not that such enhancements will result in a significant increase in functionality that is apparent to the user. For example, if existing software is modified for

making ad hoc queries, the cost shall be capitalized if it exceeds the capitalization threshold. The cost of routine or minor changes or modernizations that do not significantly add functionality shall be expensed. Examples include updating data tables, web-enabling, customizing reports or changing Graphic User Interfaces. Also, the cost of enhanced versions of software for a nominal charge is expensed.

2. The cost incurred solely to repair a design flaw or to perform minor upgrades that may extend the useful life of the software without adding new capabilities shall be expensed. This includes updating the technical platform of a system.

I. Impairment

1. Post Implementation/Operational Software

a. Impairment shall be recognized and measured when one of the following occurs and is related to post implementation/operational software:

(1) The software is no longer expected to provide substantive service potential and will be removed from service, or

(2) A significant reduction occurs in the capabilities, functions or uses of the software (or a module thereof).

b. If the impaired software is to remain in use, the loss due to impairment shall be measured as the difference between the book value and either:

(1) The cost to acquire software that would perform similar remaining functions (e.g., the unimpaired functions) or, if that is not feasible,

(2) The portion of the book value attributable to the remaining functional elements of the software. The loss shall be recognized upon impairment, and the book value of the asset reduced accordingly. If neither (a) nor (b) above can be determined, the book value shall continue to be amortized over the remaining useful life of the software.

c. If the impaired software is to be removed from use, the loss due to impairment shall be measured as the difference between the book value and the net realizable value (NRV), if any. Typically, the NRV will be zero (0). The loss shall be recognized upon impairment, and the book value of the asset reduced accordingly.

2. Termination of Software Under Development. When it is determined that software under development (or a module thereof) will not be completed and placed in service, the accumulated development costs (or the balance in a work-in-process account) should be reduced to reflect the expected NRV, if any, and the loss recognized.

J. Depreciation

1. Software that is capitalized shall be depreciated as provided for in this chapter. The DoD Standard Recovery Period used for depreciation shall be consistent with that used for planning the software's acquisition. See DoD Financial Management Regulation, Volume 4, Chapter 6, Table 6-7, DoD Recovery Periods for Depreciable General PP&E Assets for the specific recovery periods (useful lives) for software.

2. For each module or component of a software project, depreciation should begin when that module or component was successfully tested. If the use of a module is dependent on completion of another module(s), the depreciation of that module shall begin when both that module and the other module(s) have successfully completed testing.

3. When Internal Use Software is replaced with new software, the undepreciated cost of the old software shall be expensed when the new software successfully completes testing. No adjustments will be made to the previously recorded depreciation.

4. Software that is developed by one activity and used by another activity or activities without reimbursement shall be capitalized and depreciated by the developing activity. The depreciation expense related to such software shall not be allocated to the using activities.

5. Internal Use Software must be accounted for in an automated property accountability system that is Joint Financial Management Improvement Program (JFMIP) compliant.

6. Figure 2, below, provides a decision tree to assist in determining if an Internal Use Software project shall be capitalized.

K. Disclosures. Annual financial statement disclosures required for Internal Use Software are the same as that for other General PP&E. Thus, the following shall be disclosed in the financial statements:

1. The cost, accumulated depreciation and net book value.

2. The estimated useful life.

3. The method of depreciation (straight-line).

L. Accounting Entries. Internal Use Software Account 1830 shall be used to record the cost of Internal Use Software. Table 1, below, illustrates common example entries for the account.

ACCOUNTING ENTRIES TO ACCOUNT 1830
INTERNAL USE SOFTWARE

1.	Dr	1830 Internal Use Software
	Cr	2110 Accounts Payable
		To record the acquisition cost incurred by the DoD for purchased software.
2.	Dr	1832 Internal Use Software In Development
	Cr	6610 Cost Capitalization Offset
		To record cost incurred for software under development.
3.	Dr	1830 Internal Use Software
	Cr	1832 Internal Use Software In Development
		To transfer cost of software under development to the software account upon completion of acceptance testing.
4.	Dr	6710 Depreciation, Amortization and Depletion
	Cr	1839 Accumulated Depreciation on Internal Use Software
		To record depreciation expense for the current accounting period.
5.	Dr	1839 Accumulated Depreciation on Internal Use Software
	Dr	7210 Other Losses
	Cr	1830 Internal Use Software
		To write off unusable software that has already been placed in service, but is no longer useful.
6.	Dr	1839 Accumulated Depreciation on Internal Use Software
	Cr	1830 Internal Use Software
		To write off fully depreciated Internal Use Software upon disposal.

Table 1

INTERNAL USE SOFTWARE CAPITALIZATION DECISION TREE

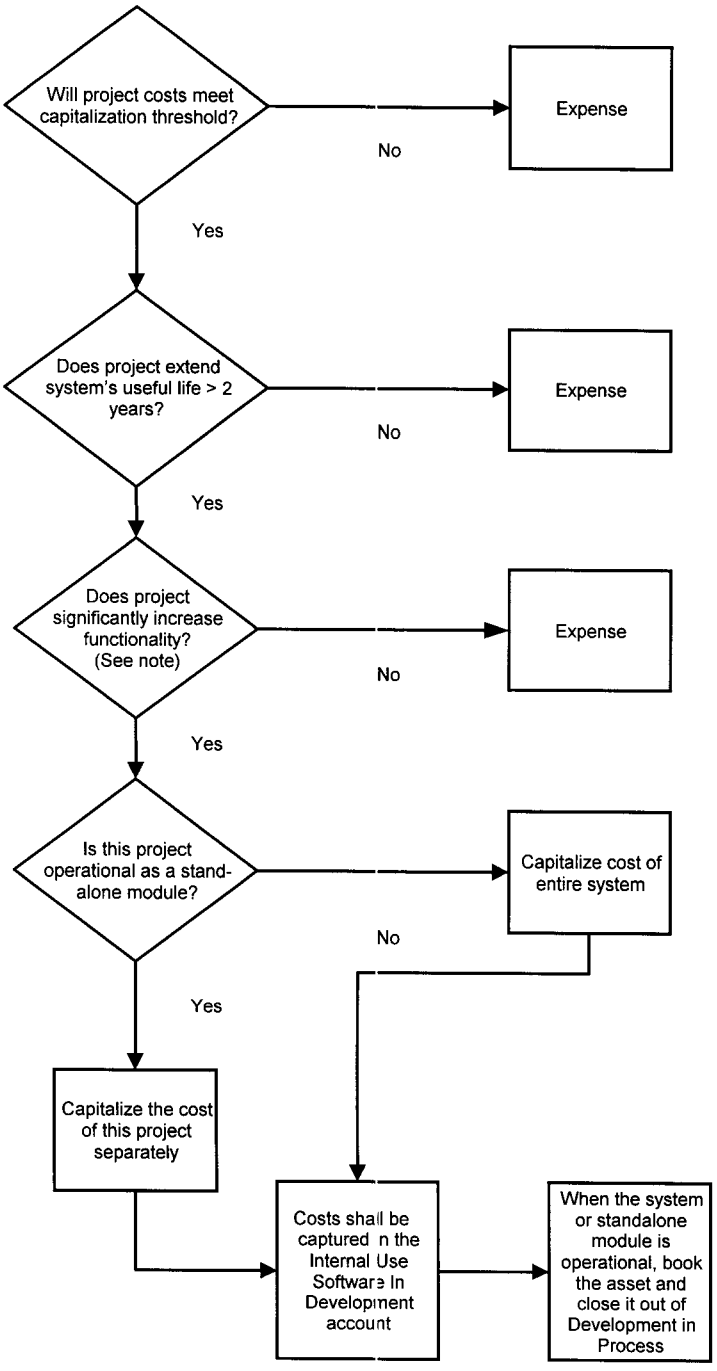

Figure 2